United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-7305

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 76-7305

JAMES ARNEIL and VERNON A. STOCKWELL,

Plaintiffs-Appellants,

—against—

JAMES B. RAMSEY, JR., OLIVER DEG. VANDERBILT, WILLIAM M. LENDMAN, BLAIR & CO., INC., and THE NEW YORK STOCK EXCHANGE,

Defendants-Appellees.

On Appeal from the United States District Court For the Southern District of New York

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BRIEF FOR DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

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NEW YORK STOCK EXCHANGE, INC.

Statement of the Issues

The issues on this appeal are:

1. Whether the claims based on Section 6 of the Securities Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78f (1970), are governed by the three-year statute of

limitations for liability created or imposed by statute (CPLR § 214(2)) or the six-year statute for contract claims (CPLR § 213(2)).

2. Whether plaintiffs lack standing to assert claims based on Section 6 of the Exchange Act.

3. Whether an action may be maintained against the New York Stock Exchange ("the Exchange") for an alleged failure to enact certain rules.

4. Whether the claims based on Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1970), and common law fraud are governed by the Washington statute of limitations.

5. Whether the Exchange, in regulating a member firm under Section 6 of the Exchange Act, may be liable as a "controlling person" of the member firm under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (1970).

Statement of the Case

Plaintiffs James Arneil and Vernon A. Stockwell, both residents of the state of Washington, commenced this action on April 11, 1975. It involves the Exchange's regulation of Schwabacher & Co., a member firm of the Exchange, and Blair & Co., Inc. ("Blair"), a member corporation which acquired Schwabacher in 1969, and the sale by Blair of its own common and preferred shares to plaintiffs and subordinated loans made by plaintiffs to Blair. Named as defendants are the Exchange, a not-for-profit corporation organized under New York law and registered as a national securities exchange under Section 6 of the Exchange Act, Blair, James B. Ramsey, Jr., a former president of Blair, Oliver DeG. Vanderbilt, a former chair-

man of the board of Blair, and William M. Lendman, a former president of Blair.

The Exchange answered the complaint on July 10, 1975 (JA* 31-37) and moved for summary judgment on all counts on January 12, 1976 (JA 194-95). Defendants Ramsey, Vanderbilt and Lendman also answered the complaint (JA 38-44) and moved for summary judgment (JA 45). Blair obtained a judgment on November 14, 1975, permanently enjoining plaintiffs from prosecuting this action against Blair. *In re Blair & Co., Inc.*, 70 B. 755 (S.D.N.Y. Nov. 14, 1975).

The grounds for the Exchange's motion for summary judgment were that the claims were barred by the statute of limitations, that the Exchange's actions were undertaken in order to, and in fact did, satisfy the duty imposed by Section 6 of the Exchange Act, and that the Exchange made no representations to plaintiffs in connection with their purchase of Blair securities and could not be held responsible for any fraudulent conduct by others about which it had no knowledge or reasonable means to obtain knowledge. Defendants Ramsey, Vanderbilt and Lendman moved for summary judgment on the ground that all claims against them were barred by the statute of limitations. The motions were based upon the depositions of plaintiffs, the depositions of Ramsey, Vanderbilt and Lendman and the affidavit of Robert M. Bishop, senior vice president of the Exchange in charge of regulation and surveillance of member organizations (JA 196-405).

On May 12, 1976, Judge Brieant issued his opinion and order granting the motion of defendants Ramsey, Vanderbilt and Lendman in its entirety and granting the motion of the Exchange dismissing Counts I, II, III, IV, VI, IX, X, XII, XIII and XIV. 414 F.Supp. 334 (S.D.N.Y. 1976) (JA 514-40). The Court's opinion also directed the entry of final judgment pursuant to Rule 54(b) (JA 537-38).

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* "JA" refers to the Joint Appendix.

Statement of Facts

Plaintiffs are residents of the state of Washington and maintained a brokerage account with Blair in 1969 (JA 99, 100, 138-39). Each had a net worth of $1 million in 1969 (JA 87, 97). Arneil was a partner of a law firm in Washington and Stockwell owned and managed two orchards (JA 84, 92). Plaintiffs had maintained brokerage accounts, including a joint account, with a number of different firms (JA 102-104). They had both been plaintiffs in similar actions against Reynolds & Co., asserting violations of Rule 10b-5 in connection with their accounts at that firm. *Stockwell* v. *Reynolds & Co.*, 252 F.Supp. 215 (S.D.N.Y. 1965).

Plaintiffs purchased securities of Blair on April 16, 1969 when Arneil sent two checks, each for $15,000 and drawn on a Washington bank, from Washington to New York, in full payment for the Blair common and preferred stock (JA 120-25). In addition, Arneil and Stockwell were each to deposit 4,600 shares of City Investing and 1,000 shares of Servotronics, with a total market value of approximately $150,000 each, in a secured demand note account which could be used by Blair as net capital under the Exchange's net capital rule. On April 16, Arneil also sent certificates for 2,300 shares of City Investing and 1,000 shares of Servotronics from Washington to New York on behalf of Stockwell and certificates for the equivalent of 4,600 shares of City Investing from Washington to New York on his own behalf (JA 120). These transfers of cash and securities from Washington to New York constituted the major portion of their investment in Blair. In addition, Arneil forwarded the documents which plaintiffs had executed in Washington in connection with this transaction (JA 120).

Among the documents were applications to the Exchange for approval as non-voting shareholders and subordinated lenders to a member corporation. These were submitted to

the Exchange as required by Exchange Rules 311 and 312 and were reviewed by the Exchange to obtain assurance as to plaintiffs' integrity and related qualifications (JA 197-98). The Exchange made no representations to plaintiffs in connection with their purchases of Blair stock or the subordinated loans and did not know of any statements made to plaintiffs by representatives of Blair (JA 187). All of plaintiffs' conversations with Blair concerning the proposed purchase of securities of Blair were telephone conversations in which plaintiffs were in Washington and the Blair representatives were in New York (JA 140-41, 143-44).

Plaintiffs' claims of fraud are based on this sale of securities by Blair and an alleged failure to disclose "risk factors" arising from the financial and operational condition of Blair and its Schwabacher division (JA 13-14). The condition of Schwabacher as it existed before it was acquired by Blair was fully described in a Wall Street Journal article on August 29, 1969 (JA 357) which reported on the release by the Securities and Exchange Commission ("the Commission") concerning violations of recordkeeping regulations by Schwabacher & Co. (JA 351-56).

The declining position of Blair was specifically disclosed to plaintiffs in a letter to stockholders dated March 24, 1970 which referred to "badly needed senior capital" and the "absence of any book value for either the Preferred Stock or the Common Stock" (JA 155-57). On July 23, 1970, Stockwell, acting for himself and Arneil, wrote to Ramsey, referred to the March 24, 1970 letter (JA 168-69), and stated:

> "The extremely critical nature of Blair's problems were not known by us until this time.
>
> * * *
>
> "Proper disclosure of impending developments of the affairs of Blair & Company, Inc., having a material bearing on our willingness to participate in a 'Secured

> Demand Notes and Stock Purchase Agreement' has not been made to us by Blair & Company, Inc." (JA 168-69)

On July 24, 1970 Stockwell again wrote to Ramsey, stating:

> "I further want you to know that we will take immediate action against Blair & Co. [and] against any individual representing Blair & Co. who disposes of this stock in any way except by returning the stock to us." (JA 170-72)

Plaintiffs now admit they became aware of the allegedly undisclosed problems of Blair at that time (Br.* 8).

Blair's difficulties were again disclosed in a letter dated August 5, 1970 which advised plaintiffs that the securities in their subordinated accounts would be converted into cash in order to provide the maximum amount of working capital for Blair (JA 162-67).

On August 13, 1970, the Exchange announced that Blair had terminated its public business because of capital problems and might require Exchange financial assistance (JA 177-79). This news release was reported in the Wall Street Journal on August 14 (JA 180-81). At a meeting of Blair's subordinated lenders held in New York on August 21, 1970 plaintiffs were represented by the same counsel who had prosecuted their Rule 10b-5 claims against Reynolds & Co. (JA 183-84). By letter dated September 25, 1970, plaintiffs were advised that the Exchange had appointed a liquidator for Blair and that subordinated lenders were invited to attend a meeting with the liquidator to discuss the future outlook of the firm (JA 107-08). On September 29, 1970, an involuntary petition in bankruptcy was filed against Blair. *In re Blair & Co., Inc.*, 70 B. 755 (S.D.N.Y.).

* "Br." refers to Brief for Plaintiffs-Appellants.

Summary of Argument

All of the claims based upon Section 6 should be governed by the three-year statute of limitations in CPLR § 214(2). Adoption of this time period is consistent with interpretations of New York statutes of limitations and implements the federal policy concerning limitations of actions found in the Exchange Act itself. As an alternative, this Court may adopt the three-year period provided in analogous provisions in the Exchange Act.

Plaintiffs lack standing to assert claims based on Section 6 because they are not within the class for whose especial benefit the Exchange Act was enacted. The Exchange's enforcement of the rules which are the subject of this action is for the benefit of public customers of member firms. It would be inconsistent with the purposes of the Exchange Act to require these rules to be enforced to benefit capital contributors at the expense of public customers.

Plaintiffs do not contend on this appeal that Counts VI, IX and X state a claim based on Section 6(a)(2), (3) and (4) or that Count XIV states a claim for breach of fiduciary duty. Accordingly, the judgment must be affirmed as to the dismissal of those counts. The dismissal of Count XII should be affirmed since Section 6 does not support a private action against an exchange for an alleged failure to enact certain rules.

The claims based on Section 10(b) and common law fraud were properly dismissed as barred by the Washington statute of limitations. The application of New York's "borrowing statute," CPLR § 202, implements a policy of barring claims against New York residents which are barred in other states where they could have been brought.

The dismissal of Count IV, based on "controlling person" liability under Section 20(a) of the Exchange Act, should be affirmed because the Exchange cannot become a controlling person by exercising its regulatory duty imposed by Section 6 of the Exchange Act.

Argument

POINT I

The Section 6 Claims Are Barred by the Statute of Limitations.

Judge Brieant dismissed four of the eight counts which were based on Section 6 of the Exchange Act. He initially considered whether these claims were barred by the applicable statute of limitations. In finding that they were not barred, Judge Brieant relied on the decision in *Weinberger* v. *New York Stock Exchange,* 335 F.Supp. 139 (S.D.N.Y. 1971), in which Judge Gurfein determined that the agreement required by Section 6(a)(1) of the Exchange Act created third-party beneficiary rights and that a Section 6 claim "should be governed by the limitations period applicable to contract actions and not by the shorter period applicable to actions for breach of a statutory duty." 414 F.Supp. at 340 (JA 528). Judge Brieant also noted that the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 104 (June 4, 1975) eliminated any reference to an "agreement" in Section 6. 414 F.Supp. at 340 n.3 (JA 539-40).

Having made this preliminary determination, Judge Brieant dismissed three of the counts under Section 6 because they were based on portions of Section 6 which "impose no contractual duties on the Exchange," and one count because it was based on allegations which did not constitute any breach of duty under Section 6. 414 F.Supp. at 341-42 (JA 529-32).

The dismissal of these four counts was appropriate not only for the reasons given by the lower court but also because all of the Section 6 claims should be barred by the statute of limitations. The decision in *Weinberger, supra,* has never been subjected to appellate scrutiny since the action was dismissed on the merits by Judge Bonsal after

the action was submitted to the court on a stipulated record in lieu of trial and no appeal was taken. *Weinberger* v. *New York Stock Exchange,* 403 F.Supp. 1020 (S.D.N.Y. 1975). The initial decision in *Weinberger* served as a basis for Judge Lasker's decision in *Lank* v. *New York Stock Exchange,* 405 F. Supp. 1031 (S.D.N.Y. 1975), and for other lower court decisions. *Fischer* v. *New York Stock Exchange,* 408 F.Supp. 745, 757 (S.D.N.Y. 1976) (Lasker, J.); *Carr* v. *New York Stock Exchange,* 414 F.Supp. 1292, 1298 (N.D. Cal. 1976) (applying four-year California contract limitation); *Verace* v. *New York Stock Exchange,* 76 Civ. 613 (S.D.N.Y. Sept. 22, 1976) (Pierce, J.). However, in *Wilson* v. *Meyerson & Co.,* Civ. No. 72-1293 (N.D. Cal. April 7, 1976), the court applied the three-year California statute of limitations for liabilities created by statute. The question of the appropriate statute of limitations for claims under Section 6 has been certified for appellate review in *Lank,* Docket No. 76-7243 (2d Cir. 1976).

The reasoning of the district courts in *Weinberger* and *Lank* should be rejected by this Court and a three-year statute of limitations should be applied to all claims based on Section 6. The application of that statute of limitations would bar not only the four counts which were dismissed but also the remaining four counts and would obviate any need for trial.

A. The only liability imposed on the Exchange for failure to enforce its rules is for the breach of a federally-created statutory duty.

The relevant provisions of Section 6 are subparagraphs (a)(1), (b) and (d) which provide:

"SEC. 6. (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agree-

ments, setting forth the information, and accompanied by the documents, below specified:

> "(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;
>
> * * *
>
> "(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or discipling of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.
>
> * * *
>
> "(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange."

Section 6, by its express terms, imposes no duty upon a national securities exchange to enforce its own rules. That duty was implied by this Court in *Baird* v. *Franklin*, 141 F.2d 238, 244 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944). This Court in *Baird* also determined that a private right of enforcement should be implied under the Exchange Act

for members of the investing public to enforce this implied duty.

In *Baird,* this Court based the duty and the private right of action on Sections 6(b) and (d). In *Weinberger, supra,* the district court found that the agreement required by Section 6(a)(1) also created a private right of action. Judge Gurfein found that there was a "contract" between the Exchange and the Commission. 335 F.Supp. at 145. He found that the "contract" created third-party beneficiary rights because a "virtually coterminous" duty was already imposed by the statute itself. 335 F.Supp. at 144 n.10. Judge Gurfein declined to apply the limitations which would be placed on the remedy for a breach of the statutory duty and gave expansive scope to the remedy for the same conduct of an exchange now labeled as a breach of a "contractual duty." 335 F.Supp. at 145.

This decision lacks a solid foundation because the agreement required by Section 6(a)(1) does not impose any duty or grant any benefits that do not already exist by virtue of the statute. Hence, it is an exaggeration and a mischaracterization to call the relationship contractual. Moreover, as Judge Gurfein found, the only basis for implying that any "contract" was intended to afford third-party beneficiary rights is that the statute itself, as interpreted in *Baird v. Franklin, supra,* created a duty for the benefit of public investors. 335 F.Supp. at 144. Thus, it must be recognized that there is only a single duty imposed upon the Exchange by virtue of its registration as a national securities exchange under Section 6 and that the duty is a duty created by statute.

The Exchange Act created a unique system of "self-regulation" which relied, as a matter of practicality, on Exchange personnel and experience because direct governmental intervention was thought to be "ineffective, if not infeasible." *Report of the Special Study of the Securities Market,* H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 4, at 501-

02 (1963). The registration provision of Section 6 was couched in seemingly voluntary terms of an "agreement" in order to encourage the self-regulators to assume initiative and responsibility in enforcing compliance with "ethical as well as legal standards." See *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 371 (1963) (Stewart, J., dissenting). The ultimate power of oversight was retained in the Commission in Sections 19(a) and (b).

A claim against the Exchange for failure to enforce its own rules did not exist at common law and jurisdiction of such claims is now vested exclusively in the federal courts by virtue of Section 27 of the Exchange Act. *New York Stock Exchange* v. *Goodbody & Co.,* 42 App. Div. 2d 556, 345 N.Y.S.2d 58 (1st Dep't 1973); *Raldiris* v. *Simmons,* 242 App. Div. 603, 271 N.Y.S. 1018 (1st Dep't 1934), *aff'd,* 266 N.Y. 577, 195 N.E. 208 (1935); *Morganbesser* v. *New York Stock Exchange,* CCH Fed. Sec. L. Rep. ¶ 93,210 (Sup. Ct. Nassau Co. 1971); *New York Stock Exchange* v. *Pickard & Co.,* 282 A.2d 651 (Del. Ch. 1971); *Krasnow* v. *Kern Securities Corp.,* 175 N.Y.L.J., May 17, 1976, p. 8, col. 6 (Sup. Ct. N.Y. Co.).

The fact that the duty of exchanges to regulate their members is a duty "created by" Section 6 of the Act has been clearly recognized. For example, in *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 351-53 (1963), the Supreme Court recognized what it termed a "great latitude" given exchanges before enactment of the Exchange Act. The "governmental entry" gave the Commission oversight of the traditional self-regulation of exchanges and gave birth to what the Court called "the federally mandated duty of self-policing by exchanges." 373 U.S. at 352.

The conclusion in *Weinberger* that the agreement required by Section 6(a)(1) "achieves a status of its own as a contract" 335 F.Supp. at 145, is unsupported by the authority relied upon. In each case cited the contract had

independent significance even though it also expressed a duty required by the statute. The independent significance of these contracts was the result of the duties and benefits bestowed in them which were independent of any statute. Moreover, in many of the cases the statute of limitations was not at issue.

For example, in *Fata* v. *S. A. Healy Co.*, 289 N.Y. 401, 46 N.E.2d 339 (1943), the contract was a public works contract in which defendant had agreed to construct public works for a city board of water supply. The contract, pursuant to a New York statute, was required to state that each laborer would be paid wages as provided in the statute. Plaintiff sued to recover the difference between what he was paid and an amount specified in the contract. The contract was not entered into merely to impose a duty on a government contractor to pay statutory wages but fulfilled the independent function of creating duties and benefits for both the contractor and the city in respect to the construction project. In addition, the contract did not merely recite the obligations in the terms of the statute. The contract contained a more detailed agreement to pay wages as fixed in a schedule annexed to the contract. The court held:

> "The obligation thus assumed by the contractor is precise, and extends beyond the scope of the statutory obligation. The statutory remedy provided for breach of the statutory obligation would be an inadequate and unsuitable remedy for a violation of this contractual obligation." (289 N.Y. at 406-07)

Filardo v. *Foley Bros.*, 297 N.Y. 217, 78 N.E.2d 480 (1948), *rev'd on other grounds,* 336 U.S. 281 (1949), the next case cited in *Weinberger,* also involved a public works contract—a construction contract with the United States government. A federal statute required the contractor to pay time and one-half for overtime. The construction contract provided that the defendant would "obey and abide by

all applicable laws . . . of the United States." There was no doubt that the contract had a status independent of the statute since it covered all phases of the construction project. The court held that a laborer had an implied right to recover for the contractor's failure to pay overtime wages both because such a right effectuated the purpose of the statute and because the laborer was a beneficiary of the construction contract, but it did not consider the statute of limitations.

Similarly, in *United States ex rel. Johnson* v. *Morley Construction Co.,* 98 F.2d 781, 788-89 (2d Cir. 1938), and in *Lemon* v. *Bossier Parish School Board,* 240 F.Supp. 709 (W.D.La. 1965), *aff'd,* 370 F.2d 847 (5th Cir. 1967), the contracts sued upon existed for a purpose other than merely to recite a preexisting statutory duty. The contracts involved in those cases, a government construction contract and a government loan agreement, imposed burdens and gave benefits which had no relationship to a statutory duty.

The only case cited in *Weinberger* to support its view that the agreement required by Section 6(a)(1) is "a separate contract supported by mutual consideration," 335 F.Supp. at 134 n.12, is *Fryns* v. *Fair Lawn Fur Dressing Co.,* 114 N.J.Eq. 462, 168 A. 862 (1933). In that case the consideration for a "re-employment agreement" with the President of the United States under the National Industrial Recovery Act of 1933 was found to be "the benefit of the pledge of all other members of N.R.A. to patronize their fellow members" (168 A. at 865) and seems plainly irrelevant.

The statutory scheme of the Exchange Act indicates that the use of the word "agreement" in Section 6 was not intended to create a contractual relationship. Section 5 of the Act makes it unlawful to use the facilities of an exchange unless the exchange is either registered under Section 6

or exempted from registration. It is apparent that the inclusion of the required "agreement" in a registration statement is merely a condition precedent to the grant of a license and creates no "contractual" relationship. The term "license" has been clearly defined by a three-judge district court in *Palmetto Fire Ins. Co.* v. *Beha,* 13 F.2d 500, 505 (S.D.N.Y. 1926):

> "A license is merely a permit or privilege to do what otherwise would be unlawful. The purpose of it is to regulate and control the manner in which the business is conducted, and prevent its being carried on in such a way as to injure public interests. And it may be issued for both regulation and revenue. A license is a mere privilege, and is not a contract. [citations omitted] And it has been held not to create a vested right."

See *Madden* v. *Queens County Jockey Club, Inc.,* 296 N.Y. 249, 255, *cert. denied,* 332 U.S. 761 (1947).

The agreement required by Section 6(a)(1) does not create a contractual relationship since the purported "contract" is illusory. The Exchange acquired no vested contractual or property rights by becoming registered under Section 6. The rights acquired by the Exchange are subject to such conditions and restrictions, and amendments to or revocations of such conditions and restrictions, as Congress sees fit to impose. See, *e.g., Fochi* v. *Splain,* 36 N.Y.S.2d 774 (Sup.Ct. N.Y.Co. 1942). The right of the Exchange to conduct its business is not a "franchise," as the *Weinberger* court implies in footnote 12, since a "franchise" cannot be taken away by the United States except under the power of eminent domain. See, *e.g., New Orleans Gas Co.* v. *Louisiana Light Co.,* 115 U.S. 650, 673 (1885). The Section 6(a)(1) agreement imposes no new duties upon the Exchange that are not already imposed by the statute

itself. As the New York Court of Appeals stated in *Schram* v. *Cotton,* 281 N.Y. 499, 507 (1939):

> "A voluntary promise to assume a duty or liability, which the law imposes even where there is no promise, creates no new duty or liability."

In sum, an exchange gains, by the filing of the Section 6(a)(1) agreement in its registration statement, no rights except the right to engage in a business that is otherwise made illegal.

None of the cases cited in *Weinberger* and discussed above involved the issue of the applicable statute of limitations. In *Fata* v. *S.A. Healy Co.*, the following statement was made:

> "[I]n many cases—perhaps in most cases—limitations not only of the scope of the statutory obligation but also of the remedy for its violation may apply also to the contractual obligation formulated in the same language." (289 N.Y. at 406)

This language suggests that the New York court would adopt the same statute of limitations applied to the statutory right where the "contractual" duty is coterminous.

This was the approach followed by the Court in *Schram* v. *Cotton,* 281 N.Y. 499 (1939). Defendant in that action was sued by the receiver of an insolvent national bank for recovery of the double liability imposed by the statute on stockholders of national banks. Defendant had consolidated his stockholdings with other stockholders in a holding company. The articles of association of the holding company provided that the stockholders "severally agree that such liability may be enforced in the same manner and to the same extent as statutory liability." Defendant argued that a three-year statute of limitations for liability created by statute found in N.Y. Code of Civil Procedure § 394 was to be applied instead of the six-year contract statute of limi-

tations in N.Y. Code of Civil Procedure § 382(1). The court adopted the three-year period for liabilities created by statute. Judge Lehman, after reciting the principle that the contractual assumption of a duty already imposed by the law in the absence of such a promise creates no new duty or liability, stated:

> "To hold that the action to enforce the statutory liability imposed upon stockholders of the bank, which has been expressly assumed by the stockholders of the dominant corporation, is governed by a different Statute of Limitations from that which governs an action to enforce the statutory liability impliedly assumed by the stockholders of the bank when they acquire their stock, would exalt form over substance." (281 N.Y. at 507)

Accord, *Platt* v. *Wilmot,* 193 U.S. 602, 613 (1904) ("It is a liability created by the statute, because the statute is the foundation for the implied contract . . . ."); *McClaine* v. *Rankin,* 197 U.S. 154, 162 (1905).

Similarly, in *Abram* v. *San Joaquin Cotton Oil Co.,* 46 F.Supp. 969 (S.D.Cal. 1942), the court was faced with a statute of limitations issue in a laborer's action for overtime compensation and rejected a defense that the cause of action was subject to a two-year statute of limitations for contract actions rather than a three-year statute for liability created by statute.

Accord, *Lorenzetti* v. *American Trust Co.,* 45 F.Supp. 128, 139 (N.D.Cal. 1942), *rev'd on other grounds,* 137 F.2d 742 (9th Cir. 1943); *City Messenger Service, Inc.* v. *Capitol Records Distributing Corp.,* 327 F.Supp. 970, 973 (S.D. Ohio 1970), *aff'd,* 446 F.2d 6 (6th Cir. 1971), *cert. denied,* 404 U.S. 1059 (1972) ("the statute is as necessary a basis for the plaintiff's cause of action as it is for the jurisdiction of this Court"); *Hire* v. *E.I. duPont de Nemours & Co.,* 324 F.2d 546, 551 (6th Cir. 1963) ("the Labor Agreement provided for the benefit but the Act gave it vitality . . . .").

The single case dealing with a statute of limitations issue cited in the *Weinberger* decision is *People* v. *Corcillo,* 195 Misc. 198, 88 N.Y.S. 2d 534 (Sup. Ct. Albany Co. 1949), *aff'd,* 276 App. Div. 675, 97 N.Y.S. 2d 319, *leave to appeal denied,* 277 App. Div. 911, 98 N.Y.S. 2d 592 (3d Dep't 1950). But even that case did not involve the applicability of a contract statute of limitations as opposed to the statute of limitations for liabilities created by statute. Defendant in *Corcillo* sought to invoke a two-year statute of limitations in N.Y. CPA § 50(2) which was applicable to actions "upon a statute for a forfeiture or penalty to the people of the state." The statute of limitations for liabilities created by statute was at the time six years as set forth in N.Y. CPA § 48(2), which applied to action "to recover upon a liability created by statute, except a penalty or forfeiture." In *Corcillo,* the Supreme Court merely concluded that CPA § 48 was applicable since the recovery was not for a penalty or forfeiture. It was not necessary to choose between CPA § 48(1), applying a six-year statute to contracts, and CPA § 48(2), applying a six-year statute to liability created by statute. The court stated:

> "The . . . fact that the violations of the conditions of the bond constitute the identical violations of the statute, do not transform the actions on the bonds into actions to recover *penalties* fixed by statute." (emphasis added) (88 N.Y.S.2d at 536)

The court in *Corcillo* did not reject the reasoning of *Schram* v. *Cotton, supra,* or the suggestion in *Fata* v. *S.A. Healy Co., supra,* that the statute of limitations for liability created by statute was applicable when "the contractual obligation [is] formulated in the same language [as the statutory obligation]." 289 N.Y. at 406.

The proper test to determine whether Section 214(2) of the CPLR is applicable was established by the New York Court of Appeals in *Frank Shepard Co.* v. *Zachary P. Taylor Publishing Co.,* 234 N.Y. 465, 138 N.E. 409 (1923). That decision found the limitations for liability created by

statute to be applicable where the liability "did not exist at common law. 'Liability created by statute' means a liability which would not exist *but for* the statute." (emphasis added) 234 N.Y. at 468. The New York courts have adhered to this settled rule. In *Bevelander* v. *Town of Islip,* 10 App. Div. 2d 170, 171-72, 199 N.Y.S.2d 561 (2d Dep't 1960), the court said:

> "The term 'a liability created by statute,' as employed in this Statute of Limitations, has been defined as 'a liability which would not exist but for the statute' (Shepard Co. v. Zachary P. Taylor Pub. Co., 234 N.Y. 465, 468, 138 N.E. 409, 410; see, also Schmidt v. Merchants Despatch Transp. Co., 270 N.Y. 287, 305, 200 N.E. 824, 829; 53 C.J.S. Limitations of Actions § 83, subd. (a), p. 1051 et seq.; 34 Am.Jur., Limitation of Actions, § 48, p. 48). A proper test of whether a particular liability is 'a governmental statutory denouncement of a human action heretofore undenounced' (Fratt v. Robinson, 203 F.2d 627, 635, 37 A.L.R.2d 636)."

As Judge Lasker recognized in *Lank* v. *New York Stock Exchange, supra:*

> "There is appeal to the rather straightforward proposition that an action based on § 6 of the Securities Exchange Act is one which seeks to recover on a liability created by statute and is therefore governed by the three year period." (405 F.Supp. at 1039)

Section 6 imposes a duty on the Exchange to enforce its own rules. If there is also a "contractual duty," it is identical to the statutory duty and depends upon the statute for its existence. Moreover, the duty to enforce rules did not exist before the statute was enacted. But for Section 6, the duty to enforce rules—and thus any cause of action for breach of the duty—would not exist.

The nature of the relevant proof in a Section 6 action also indicates that the claim is more analogous to a tort claim implied from the violation of a statutory duty or a negligence claim, both of which are governed by the three-year statute of limitations in CPLR § 214. The issues involved in a Section 6 action are what the Exchange knew and what it did after it acquired that knowledge. *Weinberger* v. *New York Stock Exchange*, 403 F.Supp. 1020, 1028 (S.D.N.Y. 1975); *Marbury Management, Inc.* v. *Kohn*, 373 F.Supp. 140, 143 (S.D.N.Y. 1974). These are issues which commonly arise when a negligence standard is to be applied to a defendant's conduct. Factual issues which might arise in a Section 6 action are less likely to focus on more traditional contract issues such as what the parties intended as their agreement or how a writing expressing that agreement is to be interpreted and applied to their conduct.

In *Rich* v. *New York Stock Exchange*, 522 F.2d 153, 155 n.4 (2d Cir. 1975), this Court noted:

> "And subsequent decisions, while being careful not to hold the Exchange to a duty of supervision that is unrealistic have upheld claims on what is essentially a negligence standard."

Accordingly, a Section 6 cause of action exists solely by virtue of the Exchange Act and should be governed by the limitations period applicable to liability created by statute.

B. Since a Section 6 cause of action is federally-created and the applicable statute of limitations should implement the federal policy of limitations, this Court should be guided by the statutes of limitations found in the Exchange Act.

Federal courts have frequently been called upon to enforce a federally-created right for which no specific limitations period was prescribed by Congress. Faced with such

a situation in *McCluny* v. *Silliman*, 28 U.S. (3 Pet.) 270 (1830), the Supreme Court, relying upon the Rules of Decision Act in the Judiciary Act of 1789, 28 U.S.C. § 1652, applied a state statute of limitations.

It has been recognized that state law should be applied by a federal court to a federally-created right only where the state law supplements and fulfills federal policy. For example, in *Holmberg* v. *Armbrecht*, 327 U.S. 392 (1946), Justice Frankfurter found that federal courts enforcing federally-created rights have a "duty" to "apply their own principles in enforcing an equitable right created by Congress." He found that:

> "The implied absorption of State statutes of limitation within the interstices of the federal enactments is a phase of fashioning remedial details where Congress has not spoken but left matters for judicial determination within the general framework of familiar legal principles." (327 U.S. at 395)

This principle was aptly summarized by Justice White, dissenting in *United Auto Workers* v. *Hoosier Cardinal Corp.*, 383 U.S. 696, 709 (1966):

> "[T]he silence of Congress is not to be read as automatically putting an imprimatur on state law. Rather, state law is applied only because it supplements and fulfills federal policy, and the ultimate question is what federal policy requires."

State statutes of limitations are not the only ones available to this Court for application to a cause of action under Section 6. This Court may also look to analogous statutes of limitations for express liability created by the Exchange Act itself. *McAllister* v. *Magnolia Petroleum Co.*, 357 U.S. 221, 228-29 (1958) (limitations for seaman's cause of action for unseaworthiness could be measured by analogous action at law for negligence under the Jones Act) (Brennan, J., concurring). For expressly created liability under the

Exchange Act, Congress imposed a uniform nationwide limitation period on the newly-created federal rights. These statutes of limitations illustrate the federal policy as to statutes of limitations in the securities area and are a "ready and logical source to draw upon for determining the period within which this federal right may be enforced." *McAllister* v. *Magnolia Petroleum Co.,* 357 U.S. at 229.

An express liability for manipulative and fraudulent actions on a national securities exchange is created by Section 9(e) of the Exchange Act which provides:

> "No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation." (15 U.S.C. § 78i(e))

Section 18 of the Exchange Act imposes an express liability for documents filed with the Commission containing false or misleading statements. This section also provides:

> "(c) No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued." (15 U.S.C. § 78r(c))

Moreover, under Section 29, actions to void contracts in violation of the Exchange Act must be

> "brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation." (15 U.S.C. § 78cc(b))

A period of one year from discovery or three years from sale is also applicable, pursuant to Section 13, to actions under the Securities Act of 1933 for misstatements or omissions in the sale of a security. 15 U.S.C. § 77m. A two-year statute of limitations is applicable to recovery of

insider profits under Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b), and a one-year period is applicable to actions for failure to register securities under Section 5 of the Securities Act. 15 U.S.C. § 77m.

Professor Loss has suggested that use of the limitations periods in the securities laws, rather than the "grab bag of more or less analogous state statutes" for implied actions under the securities laws, would be more consistent with the statutory scheme. 6 Loss, *Securities Regulation* 3899-900 (1969). Numerous commentators have expressed a similar view. Martin, *Statutes of Limitation in 10b-5 Actions: Which State Statute is Applicable?*, 29 Bus. Law. 443, 455 n.91 (1974); Ruder & Cross, *Limitation on Civil Liability under Rule 10b-5,* 1972 Duke L.J. 1125, 1148 (1972); Israels, *Book Review,* 77 Yale L.J. 1585, 1591 (1968); Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion,* 13 Wayne L.Rev. 635, 638, 643, 649 (1967); Ruder, *Civil Liability Under Rule 10-b5: Judicial Review of Legislative Intent?*, 57 Nw. U.L.Rev. 627, 681 n.243 (1963); cf. *Mittendorf* v. *J. R. Williston & Beane Inc.*, 372 F.Supp. 821, 830 n.4 (S.D.N.Y. 1974); *Nickels* v. *Koehler Management Corp.*, CCH Fed. Sec.L.Rep. ¶ 95, 719 (6th Cir. Sept. 2, 1976).

Congress, in drafting the Exchange Act, created no statute of limitations for actions under Section 6 because it had provided no private right of action for violation of that section. Such a right of action was judicially created ten years later in *Baird* v. *Franklin, supra.* In view of the short statutes of limitations which Congress provided for express liability under the securities laws, it is wholly inappropriate to choose, as Judge Gurfein did in *Weinberger,* "that state statute of limitations which is the more liberal." 355 F.Supp. at 145.

Similarly, the policy of Congress with respect to time limitations on securities actions should not be based on what are perceived to be "extensive record keeping practices" of

the Exchange. *Lank* v. *New York Stock Exchange,* 405 F.Supp. 1031, 1040 (S.D.N.Y. 1975). This is particularly true when such records must be maintained for only five years. 17 C.F.R. § 240.17a-1 (1975). The Congressional policy is more likely to be expressed in the language which Congress used when it defined its time limitation policy in those provisions which directly impose liability.

Adoption of a period of one year from discovery or three years from the violation from the above provisions of the Exchange Act would allow for uniformity for federal courts with respect to the rights created under Section 6. As Judge Friendly pointed out in *Moviecolor Limited* v. *Eastman Kodak Co.,* 288 F.2d 80 (2d Cir.), *cert. denied,* 368 U.S. 821 (1961), with respect to rights under the Clayton Act, uniformity among the federal courts is desirable where

> "the right not merely is federally created but is enforceable only in the federal courts. . . . In this area, as contrasted with diversity litigation, federal interests transcend those of the states; state limitation statutes and doctrines were utilized to effect federal, not state, policy; and there is no reason for borrowing a state doctrine when there is an established federal one." (288 F.2d at 84-85)

This appeal and the appeal in *Lank, supra,* offer this Court the opportunity and the duty to "fashion the remedial details" of a cause of action under Section 6. In doing so, this Court is not constrained by numerous appellate decisions applying state statutes of limitations since no other appellate court has yet considered the question of the statute of limitations applicable to Section 6. If this Court wishes to identify and implement the federal policy in this respect, this Court should adopt the time period specified in the Exchange Act itself—three years after such violation and one year after the discovery of the facts constituting the violation.

POINT II

Plaintiffs Lack Standing to Assert Claims Based on Section 6.

A second, independent and sufficient reason for upholding the dismissal of certain claims made by plaintiffs under Section 6 is that they lack standing to assert them. In spite of a recent holding to the contrary by Judge Lasker in *New York Stock Exchange* v. *Sloan,* 394 F.Supp. 1303 (S.D.N.Y. 1975), a cause of action against the Exchange for failure to enforce its net capital and recordkeeping rules should be limited to that class which Congress intended to have the especial benefit of Exchange self-regulation of a member firm's operational and financial condition—public customers. If the Exchange must enforce such rules so as to prevent any loss to the capital of a member firm (which is derived in part from capital contributors such as plaintiffs), the protection afforded to the public which invests through member firms would be impaired.

The issue of standing to sue under Section 6 is also on appeal before this Court in *Lank* v. *New York Stock Exchange,* Docket No. 76-7243 (2d Cir. 1976). In that action Judge Lasker, on the basis of his decision in *Sloan,* granted standing to sue to a receiver of a member corporation. Judge Lasker certified the question for appellate review under 28 U.S.C. § 1292, finding that there was substantial ground for difference of opinion.

The Supreme Court has recently given additional guidance in *Cort* v. *Ash,* 422 U.S. 66 (1975), concerning the creation of private rights of action to enforce statutory duties on behalf of a protected class. There a shareholder sued derivatively to recover certain corporate political expenditures which were alleged to be in violation of 18 U.S.C. § 610. The Supreme Court held that the shareholder lacked standing to sue under Section 610 as a citizen, as a voter or as a

shareholder. The factors to be considered in reaching a determination of the right to sue were summarized as follows:

> "In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' *Texas & Pacific R. Co.* v. *Rigsby,* 241 U. S. 33, 39 (1916) (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? See, *e.g., National Railroad Passenger Corp.* v. *National Assn. of Railroad Passengers,* 414 U. S. 453, 458, 460 (1974) (*Amtrak*). Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? See, *e.g., Amtrak, supra; Securities Investor Protection Corp.* v. *Barbour,* 421 U. S. 412, 423 (1975); *Calhoon* v. *Harvey,* 379 U. S. 134 (1964). And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law? See *Wheeldin* v. *Wheeler,* 373 U. S. 647, 652 (1963); cf. *J. I. Case Co.* v. *Borak,* 377 U. S. 426, 434 (1964); *Bivens* v. *Six Unknown Federal Narcotics Agents,* 403 U. S. 388, 394-395 (1971); *id.*, at 400 (Harlan, J., concurring in judgment)." (422 U. S. at 78)

Application of these factors to a plaintiff's right to sue under Section 6 leads to the conclusion that only a public customer, *i.e.*, a person who invests through a brokerage firm, not a person who invests in a brokerage firm, should be found to have standing to sue in an action such as this. Public customers constitute the class for whose especial benefit the Exchange Act was enacted and the

legislative history reveals no intent to create a remedy for the benefit of anyone other than public investors. Moreover, implying a right to sue on behalf of capital contributors of member firms would be inconsistent with the application of measures to regulate the financial responsibility of member firms—an underlying purpose of the Exchange Act.

In the first case implying a private right of action under Section 6, *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944), Judge Clark, who dissented on the issue of causation, gave careful analysis to the legislative purpose and said:

> "[T]he Act was enacted for the benefit and protection of customers of members of registered exchanges and of such members of the general public, including plaintiffs, as might carry on security transactions with members of a registered exchange . . . ." (141 F.2d at 242)

and:

> "One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public." (141 F.2d at 244)

The legislative history bears out this analysis. *E.g.,* S.Rep. No. 792, 73d Cong., 2d Sess. 4 (1934) (the need for government intervention in securities regulation is to "afford protection to investors"); H.R.Rep. No. 1383, 73d Cong., 2d Sess. 1 (1934) (purpose of the Exchange Act is "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges."); 78 Cong. Rec. 2270-71 (1934) (remarks of Senator Fletcher) ("the interests of the general public are paramount" to those of insiders in stock exchanges and member firms). See also Section 6 of the Securities Investor Protection Act, 15 U.S.C. § 78fff(c)(2)(A)(ii), which defines "customer" to exclude persons who have claims for property which is part

of the capital of a broker-dealer or is subordinated to claims of creditors of a broker-dealer; this provision of SIPA expressly amends the Exchange Act, 15 U.S.C. § 78bbb.

In *Sloan, supra,* the court recognized that earlier decisions which gave consideration to a private right of action for violation of Section 6 had not provided a definitive answer to the question as to who had standing to sue under Section 6. The opinions examined in this respect by Judge Lasker included *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); *Pettit* v. *American Stock Exchange*, 217 F.Supp. 21 (S.D.N.Y. 1963); *Weinberger* v. *New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971); *Hughes* v. *Dempsey-Tegeler & Co.*, CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. 1973); *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange*, 327 F.Supp. 495 (E.D. Pa. 1971). The Court also discussed *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963), an antitrust action against the Exchange where standing was conferred by Section 4 of the Clayton Act, 15 U.S.C. § 15.

In response to the Exchange's argument that the legislative history of the Exchange Act indicates that Congress was concerned exclusively with the protection of public investors, the court recognized that "[t]here is no doubt that this was a primary purpose of the Act. . . ." 394 F.Supp. at 1308. Nevertheless, the court found that the Exchange Act had broad purposes and that

> "the requirements for standing should be flexible enough to take account of the nature and intent of the particular Exchange rule whose violation is the subject of suit." (394 F.Supp. at 1310)

Thus, the *Sloan* court found that protection of public investors was a primary purpose of the Exchange Act, *i.e.*, the Exchange Act was for the primary benefit of public investors. It did so in language strikingly similar to the language used one month later by the Supreme Court in *Cort* v. *Ash*, when it said that that plaintiff should be "one of the

class for whose *especial* benefit the statute was enacted." 422 U.S. at 78. Nevertheless, Judge Lasker concluded that the remedy could be available for others as well. This is not consistent with the later decision in *Cort* v. *Ash*. In expanding the remedy implied in *Baird* to give capital contributors in member firms a right to sue the Exchange for the manner in which it enforced its net capital and recordkeeping rules, Judge Lasker failed to recognize that it was not "consistent with the underlying purposes of the legislative scheme to imply such a remedy," as now required by *Cort* v. *Ash, supra*. Moreover, the *Sloan* court, in expanding the remedy, misapplied the flexible test which it had fashioned. The court assumed that public customers and capital contributors stood in the same relationship to the firm and to the Exchange with respect to net capital and recordkeeping rules since both "entrust their funds or securities to broker-dealers." 394 F.Supp. at 1310. The functions performed by these rules have different impacts on these two classes and consequently they cannot stand in the same relationship to the member firm or to the Exchange. Imposing a dualistic duty to enforce the net capital and recordkeeping rules to protect both public customers and capital contributors would be inconsistent with the legislative purpose.

An analysis of the net capital and recordkeeping rules shows that they were designed to protect customers who entrust cash or securities to member firms and not to protect capital contributors. Indeed, the funds of capital contributors to member firms are required for the protection of public customers. This is the primary function of the net capital rule, as recognized in *J. R. Williston & Beane Inc.* v. *Haack,* 387 F.Supp. 173, 179 (S.D.N.Y. 1974), and *SEC* v. *General Securities Co.,* 216 F.Supp. 350, 351 (S.D.N.Y. 1963). Concerning the purpose of its own net capital requirements found in Rule 15c3-1, the Commission has stated:

> "The purpose of the net capital rule is to require a broker or dealer to have at all time sufficient liquid

assets to cover its current indebtedness. The need for liquidity has long been recognized as vital to the public interest and for the protection of investors and is predicated on the belief that accounts are not opened and maintained with broker-dealers in anticipation of relying upon suit, judgment, and execution to collect claims but rather that on reasonable demand one can liquidate his cash or securities positions." (Securities Exchange Act Release No. 10209, 38 Fed. Reg. 16774 (June 8, 1973) (SEC Docket, June 19, 1973, Vol. 1, No. 19 at 12))

Rule 325 was designed to protect public customers by requiring capital contributors to commit funds which will be available for such public customers. Affording the capital contributor standing to sue under Section 6 creates a conflict in duties which is inherent in the difference in status between customers and capital contributors. When a member organization has serious financial or operational difficulties, "safeguarding" the investment of a capital contributor would generally require a different response by the Exchange than would protecting the public customers.

In *Carr* v. *New York Stock Exchange,* 414 F.Supp. 1292 (N.D.Cal. 1976), the court recognized the conflicts presented by competing obligations to public customers of member firms and to investors of member firms, stating:

> "In enforcing its rules and in making complex decisions on the suspension or forced liquidation of members, the Exchange must consider the often conflicting interests of the member firm, its partners, and investors, and the corporations whose securities are handled by the firm, as well as the Exchange's public customers. Under these circumstances it cannot be said, as plaintiffs here seem to contend, that complete suspension should automatically follow a firm's breach of Exchange rules." (414 F.Supp. at 1298)

As the district court said in *Hughes* v. *Dempsey-Tegeler & Co.*, CCH Fed.Sec.L.Rep. ¶ 94,133 (C.D.Cal. 1973), *aff'd,* 534 F.2d 156 (9th Cir.), *petition for cert. filed,* 45 U.S.L.W. 3163 (U.S. August 19, 1976) (No. 76-248), a choice between such obligations "does not seem to make sense under the Securities Exchange Act for it would at once remove fundamental flexibilities and discretions necessary for the effective functioning of national securities exchanges." (¶ 94,133 at 94,546).

As the Exchange's regulation of Schwabacher and Blair indicates, the Exchange requires member organizations with financial and operational difficulties to take appropriate remedial steps with a primary view toward protecting the customers' accounts, not the funds of capital contributors (JA200-04, 215-16). For instance, it may be in the customers' interest to restrict the business of a firm so that the customers can obtain more prompt and accurate service. On the other hand, such restrictions normally cut down on profitability, to the prejudice of a capital contributor, who may care little about when the customer gets an accurate monthly account statement but cares quite a bit about the return on his capital investment. If the member organization fails, perhaps due to a declining market or to poor management or any other reason, the Exchange's program may have fully protected the customer but not the capital contributor. The customers' accounts may have been gradually transfered out to other brokers with no disruption in a customer's control of the account, in trading, in receipt of dividends, or in any other fashion. The capital contributor might, however, recover a smaller proportion of his "investment" when the organization ultimately fails than if the Exchange had put the member organization out of business at the first sign of any difficulty and not worried about the fate of the customers' accounts. If the Exchange had immediately suspended the organization, the customer's account might have been tied up for some time with potentially extensive loss and there could

have been a serious disruptive effect on the economy and on other brokers and their customers. There can be no doubt that the Congress in 1934 and today properly would not countenance any attenuation of the protection of Section 6, which was intended to benefit the public customer, in favor of those who had opted to become capital contributors and thus an integral part of a member firm.

This regulatory approach has been approved by the Commission and by the courts. *SIPC* v. *Barbour*, 421 U.S. 412 (1975); *Rich* v. *New York Stock Exchange*, 379 F.Supp. 1122, 1127-28 (S.D.N.Y. 1974), *rev'd on other grounds and remanded*, 522 F.2d 153 (2d Cir. 1975). See the Statement of the Exchange on August 2, 1971 reported in *Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, Study of the Securities Industry, 92d Cong., 1st Sess., ser. 92.37, pt. 1, 120-22 (1971).

Judge Lasker in *Sloan* relied on *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange, supra, Silver* v. *New York Stock Exchange, supra,* and *Baird* v. *Franklin, supra,* to find that standing to sue under Section 6 should be wide-ranging. 394 F.Supp. at 1310. *Baird* involved a public customer and gives little guidance on the specific issue of standing involved here. In *Silver,* plaintiff sued under the Sherman Act for an alleged antitrust violation. Standing to sue was given by statute under Section 4 of the Clayton Act, 15 U.S.C. § 15. Moreover, Silver was a non-member broker-dealer; he was not a member of the Exchange or an investor in a member firm. In *Bright* the plaintiff sued to enforce rules governing conduct of elections. These rules served purposes quite different from those served by the net capital and recordkeeping rules involved here.

Decisions other than *Sloan* have given only cursory consideration to the standing issue. In two of them, *Hughes* v. *Dempsey-Tegeler & Co., supra,* and *Weinberger* v. *New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971), and 403 F.Supp. 1020 (S.D.N.Y. 1975), judgment on the merits

in favor of the Exchange had been entered after trial and the issue of standing was no longer pivotal.

In sum, the analysis of *Sloan* is faulty and at odds with the criteria set forth in *Cort* v. *Ash.* Capital contributors in member firms are not members of the class for whose "*especial* benefit" the statute was enacted. Expansion of the remedy to include capital contributors is inconsistent with the purposes of the statute since it does not further the purposes which the net capital and recordkeeping rules were designed to serve and limits the effectiveness of measures designed to enforce these rules.

POINT III

Section 6 Does Not Support an Action Against the Exchange for an Alleged Failure to Enact Certain Rules Different from Those Approved by the Commission.

Plaintiffs allege hypothetically that if the sale by Blair of securities to plaintiffs does not constitute a violation of the rules of the Exchange, then the Exchange failed to enact adequate rules (Count XII; JA 26-28). They also allege that the Exchange amended its Rule 313 in order to provide "for registration of member's securities under the Securities Act of 1933 and for disclosure of material risk factors" (JA 26-27). The claim, in essence, asserts that the Exchange rules at the time plaintiffs purchased Blair securities in 1969 were not adequate to meet the standard set forth in Section 6(d) of the Exchange Act, 15 U.S.C. § 78f(d), which the Commission applied before it allowed any exchange to become registered as a "national securities exchange."

Judge Brieant dismissed this claim relying on *Rich* v. *New York Stock Exchange*, 379 F. Supp. 1122 (S.D.N.Y. 1974), *rev'd on other grounds and remanded*, 522 F.2d 153 (2d Cir. 1975), and other similiar authorities. 414 F. Supp.

at 341-42 (JA 531-32). He also recognized that the absence of Rule 313(d) in 1969 was not evidence of any inadequacy of the rules of the Exchange since the Commission had approved these rules and stock in the member firms did not become freely transferable until 1970. 414 F. Supp. at 341 (JA 530-31).

Plaintiffs offer no argument that would support an action against an Exchange for failure to enact different rules (Br. 31-34). Review of the statute and the decisions rejecting a claim for failure to enact different rules reveals that plaintiffs' claim was properly rejected.

The Exchange submitted its rules to the Commission at the time of its registration as required by Section 6(a)(3) and agreed to furnish the Commission copies of any amended rules as required by Section 6(a)(4). Pursuant to Section 6(d), the Commission expressly found that these rules were "just and adequate to insure fair dealing and to protect investors" before it allowed the Exchange to become registered. This determination of adequacy is within the exclusive province of the Commission.

Moreover, the Commission also has jurisdiction to insure that the rules continue to meet these requirements by its power to alter or amend the rules pursuant to Section 19(b). If the Commission considered that it was necessary for exchanges to have different rules in 1969, it would have requested such rules. See *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659, 667 (1975) ("The congressional reports confirm that while the development of rules for the governing of exchanges, as enumerated in §19(b), was left to the exchanges themselves in the first instance, the SEC could compel adoption of those changes it felt were necessary to insure fair dealing and protection of the public.") See also *Exchange Buffet Corp.* v. *New York Stock Exchange*, 244 F.2d 507 (2d Cir. 1957); *Atlas Tack Corp.* v. *New York Stock Exchange*, 246 F.2d 311 (1st Cir. 1957). Any person may seek to have the Commission

supplement, amend or repeal these rules, with the opportunity for judicial review under Sections 2(c) and 4(d) of the Administrative Procedure Act, 5 U.S.C. §§ 551(4), 553(e).

No member firm of the Exchange was a corporation until 1953 when Exchange rules were revised to permit corporations to become members. It was not until 1970 that Exchange rules permitted any class of shares of a member corporation to be freely transferable (JA 196-97). In 1971 the Exchange revised its rules to require a member organization to file an opinion of counsel. NYSE Rule 313(d), 2 CCH N.Y.S.E. Guide ¶ 2313(d) (1971) (JA 198-200, 242-53). The opinion, which is required only if the "security is issued by the member organization for the purpose of raising capital under Rules 325 and 326," is intended to give reasonable assurance that funds which member organizations use to satisfy the Exchange's net capital requirements would not be withdrawn by investors claiming rescission for technical violations of state "blue sky" laws or of the Securities Act of 1933.

No court has ever held that a right of action is conferred upon a private party against an exchange for an alleged failure to enact certain rules. The decisions have unanimously rejected the theory upon which plaintiffs base this claim. *Kroese* v. *New York Stock Exchange*, 227 F.Supp. 519, 521 (S.D.N.Y. 1964); *Independent Investor Protective League* v. *New York Stock Exchange*, 367 F.Supp. 1376, 1377 (S.D.N.Y. 1973); *Marbury Management, Inc.* v. *Kohn*, 373 F.Supp. 140, 144 (S.D.N.Y. 1974); *Cutner* v. *Fried*, 373 F.Supp. 4 (S.D.N.Y. 1974); *Steinberg* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CCH Fed. Sec.L.Rep. ¶ 94,599 (S.D.N.Y. 1974); *Rich* v. *New York Stock Exchange*, 379 F.Supp. 1122, 1128 (S.D.N.Y. 1974), *rev'd on other grounds and remanded*, 522 F.2d 153 (2d Cir. 1975); *Weinberger* v. *New York Stock Exchange*, 403 F.Supp. 1020, 1033 (S.D.N.Y. 1975); *Carr* v. *New York Stock Exchange*, 414 F.Supp. 1292, 1299 (N.D. Cal. 1976).

POINT IV

Counts Based on Section 10(b) are Barred By the Statute of Limitations.

A. The Section 10(b) claims "arose without the state" and are barred by the three-year statute of limitations of Washington.

Plaintiffs have sued in New York with the hope of having the advantage of a six-year statute of limitations for fraud now found in New York CPLR § 213 (8)* which this Court has applied to actions based on Rule 10b-5. *Klein* v. *Shields & Co.*, 470 F.2d 1344 (2d Cir. 1972); *Hoff Research & Development Laboratories, Inc.* v. *Philippine National Bank*, 426 F.2d 1023 (2d Cir. 1970). In the absence of a federal statute of limitations applicable to actions based on Rule 10b-5, federal courts have looked to the law of the forum state for an analogous statute of limitations.**

But any reference to the law of the state of the forum, New York, also includes New York's borrowing statute, CPLR § 202, which provides:

> "An action based upon a cause of action accruing without the state cannot be commenced after the expiration of the time limited by the laws of either the

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* In 1975 New York renumbered former § 213(9), applicable to fraud, as § 213(8) because an earlier subdivision had been deleted.

** In Fischman *v.* Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951), this Court said that either the six-year statute of limitations for fraud, N. Y. CPA § 48(5), or the six-year statute of limitations for liabilities created by statute, N. Y. CPA § 48(2), applied. *Accord,* Osborne *v.* Mallory, 86 F. Supp. 869, 879 (S.D.N.Y. 1949). In Saylor *v.* Lindsley, 391 F. 2d 965, 970 (2d Cir. 1968), N. Y. CPA § 48(2) (liability created by statute) was accepted *arguendo*. In 1963 the CPLR replaced the CPA and liability created by statute became subject to a three-year limitations period. In Klein *v.* Bower, 421 F.2d 338 (2d Cir. 1970), an action based on alleged margin violations, this Court, without extended discussion, said in a footnote that if fraud allegations constituted a Rule 10b-5 claim, the six-year fraud statute would apply. In Klein *v.* Auchincloss, Parker & Redpath, 436 F. 2d 339 (2d Cir. 1971), this Court merely relied on Fischman, supra, and the footnote in Klein *v.* Bower. *Cf.* Berry Petroleum Co. *v.* Adams & Peck, 518 F. 2d 402 (2d Cir. 1975).

> state or the place without the state where the cause of action accrued, except that where the cause of action accrued in favor of a resident of the state the time limited by the laws of the state shall apply."

See, *e.g.*, *Hornblower & Weeks-Hemphill, Noyes* v. *Burchfield*, 366 F.Supp. 1364, 1367 (S.D.N.Y. 1973) (applying CPLR § 202 to claim based on alleged violation of Section 7(c) of Exchange Act).

The effect of Section 202 on the Rule 10b-5 claims raised by plaintiffs is to apply the statute of limitations of the state of Washington which bars "an action for relief upon the ground of fraud" if not brought within three years. Wash. Rev. Code 4.16.080(4). The Court of Appeals for the Ninth Circuit has held that this Washington fraud statute should be applied in cases brought under Rule 10b-5. *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (9th Cir. 1971); *Errion* v. *Connell*, 236 F.2d 447, 455 (9th Cir. 1956); *Fratt* v. *Robinson*, 203 F.2d 627, 634 (9th Cir. 1953).

Section 202 is applicable here since the cause of action "arose without the state." In *Korn* v. *Merrill*, 403 F.Supp. 377 (S.D.N.Y. 1975), *aff'd on oral opinion,* 538 F.2d 310 (2d Cir. 1976), Judge Carter gave careful consideration to New York's borrowing statute as it applies to actions based on alleged violations of securities laws, including Rule 10b-5. He found, relying upon *Sack* v. *Low*, 478 F.2d 360, 365 (2d Cir. 1973), that

> "the New York courts would follow the rule of the First Restatement of Conflicts that 'when a person sustains loss by fraud, the place of wrong is where the loss is sustained, not where fraudulent representations are made.' " (403 F.Supp. at 385)

Judge Carter also relied upon the following language found in Judge Friendly's decision in *Sack* v. *Low, supra,* 478 F.2d at 366:

> "This view is strengthened by the weight of authority in other jurisdictions, which generally adopts the

view of the First Restatement of Conflicts that a cause of action for fraud arises where the loss is sustained and that loss from fraud is deemed to be suffered where its economic impact is felt, normally the plaintiff's residence."

Here the depositions of plaintiffs show that they were residents of the state of Washington and conducted their businesses there when the allegedly fraudulent conduct occurred (JA 220, 231). All of the discussions with representatives of Blair concerning the proposed transaction with Blair occurred during telephone conversations during which plaintiffs were in Washington (JA 145-47). After plaintiffs decided to purchase stock and make a subordinated loan, they sent their checks for $15,000 each in full payment for the common and preferred stock of Blair which they purchased from Washington and mailed stock certificates for securities which were to serve as collateral for the subordinated loan from Washington (JA 120-25). Any loss resulting from their purchases of Blair securities was suffered in Washington. The cause of action, accordingly, "arose" in Washington.

Plaintiffs seek to avoid the application of the Washington statute of limitations by arguing that a recent decision in New York has applied the "center of gravity" or "grouping of contacts" doctrine of *Babcock* v. *Jackson,* 12 N.Y.2d 473, 191 N.E.2d 279 (1963), to determine where a cause of action arises. Analysis of this decision, *Federal Insurance Co.* v. *Fries,* 355 N.Y.S.2d 741 (Civ. Ct. N.Y.Co. 1974), reveals that the court used the "grouping of contacts" approach to determine not a procedural question, but a substantive question—what constitutes a conversion.

The problem confronting the court in *Federal Insurance* was that the law of each jurisdiction had a different answer to the question of what gave rise to a cause of action for conversion. Pennsylvania substantive law stated that a

cause of action for conversion accrued when defendant took possession of the property (which occurred Pennsylvania) and New York substantive law stated that such a cause of action accrued when defendant failed to return the property on demand (which occurred in New York). Even though the court held that New York substantive law governed the defendant's conduct, the claim was barred because the New York statute of limitations provided as a matter of procedure that the time to bring the action began to run from the time defendant took possession of the property (N.Y. CPLR § § 214(3), 206(a)). The court also found that even if Pennsylvania law applied to the conversion, the provisions of New York's borrowing statute (CPLR § 202) would have led New York to apply the shorter statute of limitations which in that instance was the New York statute. Thus, in *Federal Insurance,* a choice of the law to be applied to defendant's conduct was necessary to determine when the cause of action arose.

No such choice of law is necessary here since it is federal law, the Exchange Act and Rule 10b-5, which governs the defendants' conduct. New York law is consulted only as a source of the statute of limitations to be applied to a federally-created right.

Moreover, the policy of the "center of gravity" or "grouping of contacts" doctrine of *Babcock* was contrasted with the policy of the borrowing statute by Judge Friendly in *Sack* v. *Low, supra,* as follows:

> "One of the policies behind *Babcock* and many of its harbingers, such as Kilberg v. Northeast Airlines, Inc., 9 N.Y.2d 34, 211 N.Y.S.2d 133, 172 N.E.2d 526 (1961), and descendants, such as Miller v. Miller, 22 N.Y.2d 12, 290 N.Y.S.2d 734, 237 N.E.2d 877 (1968), was to afford New York residents the protection of those rules of substantive law underlying which New York had significant policies or as to which New York had important interests. In sharp contrast, the policy behind the bor-

> rowing statute is to protect New York resident-defendants from suits in New York that would be barred by shorter statutes of limitations in other states where non-resident-plaintiffs could have brought suit." (478 F.2d at 367)

Plaintiffs could have instituted this action against the Exchange in their home state of Washington. They did not, apparently because they knew it would be barred by Washington's statute of limitations.

Moreover, in *Sack* v. *Low, supra,* 478 F.2d at 368, this Court indicated that a cause of action is still deemed to have accrued "without the state" for purposes of New York's borrowing statute even where the action could be thought of as having accrued both in New York and in another state. The court said:

> "Such a rule avoids the mechanical nature of the single place of arising theory, allows the defendant to ascertain the applicable time period with certainty while affording the plaintiff a fair opportunity to sue in a convenient forum, and prevents local courts from being cluttered with actions that could have been brought elsewhere but are now time-barred there . . . ."

This view is endorsed in *Korn* v. *Merrill, supra,* 403 F.Supp. at 386 n.13.

B. The statute of limitations began to run no later than July 23, 1970.

Since, as stated in *Korn* v. *Merrill,* 403 F.Supp. 377, 387 (S.D.N.Y. 1975), federal law requires that the statute of limitations "will begin to run only from the date of discovery of the fraud or from the date the fraud should upon reasonable inquiry have been discovered," the crucial inquiry is when plaintiffs either knew or should have known the facts which they allege to constitute fraud.

There can be no doubt that by July 23, 1970, as found by Judge Brieant, 414 F.Supp. at 339 (JA 523-24), plaintiffs had actually discovered what they thought could be called a fraudulent scheme. On that date they sent a letter to the president of Blair asserting that the "extremely critical nature of Blair's problems were not known by us until this time." (JA 168-69). They also asserted in the letter that "Proper disclosure of impending developments of the affairs of Blair & Company, Inc., having a material bearing on our willingness to participate in a 'Secured Demand Notes and Stock Purchase Agreement' has not been made to us by Blair & Company, Inc." The letter of July 23, 1970 also referred to a "letter to shareholders dated March 24, 1970" from which plaintiffs had obtained information concerning the affairs of Blair. The letter to shareholders from Blair dated March 24, 1970 stated:

> "The absence of any book value for either the Preferred Stock or the Common Stock makes it impossible at the present time to sell stock of the Corporation for more than a nominal price." (JA 155-57)

Even though plaintiffs asserted a claim in their July 1970 letter that material facts had not been disclosed to them, they now contend that the statute of limitations did not begin to run at that time because this knowledge "preceded the date of Blair's bankruptcy and thus preceded the date the causes of action accrued" (Br. 23). This implies that plaintiffs suffered no loss from the fraud until the time of the bankruptcy. Any loss from fraud in connection with the purchase of securities under Rule 10b-5 must have occurred in April 1969 when plaintiffs purchased Blair common and preferred stock and executed secured demand notes and collateral agreements with Blair. If the loss did not occur until the bankruptcy, then it was caused by events other than the alleged fraudulent omissions. In any event, plaintiffs' argument establishes that the statute of limitations started to run in September 1970, more than four and one-half years before this suit was filed.

The suggestion that "plaintiffs had no awareness of possible claims against the Exchange . . . until years later" (Br. 28) is belied by the fact that the sole ground for alleging that the Exchange was involved in the fraud is that the Exchange approved plaintiffs' applications to become stockholders and subordinated lenders of Blair. Plaintiffs knew this fact in 1969. Moreover, the bankruptcy order restraining actions against Blair did not toll the statute as against other defendants (Br. 23). Plaintiffs knew they could sue other persons since they threatened to sue "any individual representing Blair & Co. who disposes of [their subordinated] stock in any way except by returning the stock to us" in their July 24, 1970 letter (JA 170-72).

Plaintiffs also contend that since the detailed facts alleged in the complaint were derived from documents received by their counsel during discovery in *Carr* v. *New York Stock Exchange,* a parallel suit, it is unreasonable to expect them independently to have discovered this evidence earlier (Br. 26). Plaintiffs' argument has been rejected numerous times by this Court. The statute of limitations for fraud begins to run at the time when plaintiffs with reasonable diligence should have and could have discovered the alleged fraud. As the court said in *Berry Petroleum Co.* v. *Adams & Peck,* 518 F.2d 402, 410 (2d Cir. 1975):

> "This court has previously noted that the time from which the statute of limitations begins to run is not the time at which a plaintiff becomes aware of all of the various aspects of the alleged fraud, but rather the statute runs from the time at which plaintiff should have discovered the general fraudulent scheme. '[T]he statutory period . . . [does] not await appellant's leisurely discovery of the full details of the alleged scheme.' *Klein* v. *Bower,* 421 F.2d 338, 343 (2d Cir. 1970)."

Other investors in Blair acted promptly. For example, John P. Foley, Jr. notified plaintiffs that an August 21,

1970 "emergency meeting of subordinated security holders" was "being called independent of Blair management to compare notes and examine our mutual interests in the light of Blair's condition and conduct" (JA 182). This meeting was attended by plaintiffs' New York counsel (JA 183-84). Approximately one month later, Foley and others commenced an action under Section 10(b) against Vanderbilt, Ramsey and others, *Foley* v. *Vanderbilt, et al.*, 70 Civ. 4914 CHT (S.D.N.Y.). In July 1971, Foley and others commenced an action against the Exchange alleging violations of Section 6 and Section 10(b). *Foley* v. *New York Stock Exchange*, 71 Civ. 2987 MEL (S.D.N.Y.). The issues in *Foley* were virtually identical to those in this case, including the propriety of the Exchange's regulation of Blair and Schwabacher during 1969 and 1970, and were presented in a four-week trial ending on June 17, 1976. Judge Lasker dismissed the Section 10(b) claims at the close of plaintiffs' case and, at the conclusion of the trial, the jury returned a verdict for the Exchange.

Plaintiffs had actual knowledge of the alleged fraud when they asserted in July 1970 that they had been defrauded and threatened to sue. Moreover, plaintiffs may be charged with knowledge of facts which would have led to the discovery of the alleged omissions even earlier. On August 28, 1969, the Commission issued its public release announcing that Schwabacher's operational status had led to violations of applicable regulations and that disciplinary measures had been imposed by the Exchange and by the Commission (JA 351-56, 357). The facts found in the release and published in the Wall Street Journal are the facts which plaintiffs claim were fraudulently omitted. There is no doubt that these facts were public knowledge on August 28, 1969 and plaintiffs can be charged with knowledge at that time.

In *Berry Petroleum Co.* v. *Adams & Peck*, *supra*, a drastic decline in the value of securities and publicity given to actions by the Commission or by private parties were

sufficient to put plaintiffs on notice and to cause the statute to begin to run. The court stated:

> "In light of the trading suspensions, the precipitous decline in the price of CUC stock, and the other lawsuits by the SEC and private parties, we think that Judge McFadden correctly concluded that plaintiffs with reasonable diligence could and should have discovered the alleged fraud prior to December 15, 1969. *Klein* v. *Shields & Co., supra,* [470 F.2d 1344, 1347 (2d Cir. 1972)]; *Azalea Meats, Inc.* v. *Muscat, supra,* [386 F.2d 5, 8-9 (5th Cir. 1967)]. See also *Hupp* v. *Gray,* 500 F.2d 993, 996-97 (7th Cir. 1974) (60% decline in stock price should have put plaintiff on notice of fraud). Since the basic facts which lead us to uphold Judge McFadden's decision appear in plaintiff's complaint, this was an appropriate case for summary judgment. See *Klein* v. *Bower, supra,* [421 F.2d 338, 343-44 (2d Cir. 1970)]; *Klein* v. *Shields & Co., supra; Rickel* v. *Levy,* 370 F.Supp. 751, 756 (E.D.N.Y. 1974)." (footnote omitted) (518 F.2d at 410-11)

See also *Winkelman* v. *Blyth & Co.,* 518 F.2d 530 (9th Cir.), *cert. denied,* 423 U.S. 929 (1975) (statute of limitations began to run when plaintiffs discovered falsity of representations as to worth of stock and such discovery gave sufficient notice to commence running of the statute as to entire action for fraud including alleged nondisclosures).

This is not a case where the discovery of the fraud must be based on what plaintiffs "should have known" since there is uncontroverted evidence that there was actual knowledge of the alleged fraud on July 23, 1970. The letter from plaintiffs to Ramsey asserts that actual knowledge (JA 168-69). The statute of limitations on the claim began the run on that date at the very latest.

C. The statute of limitations was not tolled by the *Carr* action until plaintiffs became "asserted members" of the alleged class.

The claims which are asserted against the Exchange in this action are substantially similar to claims asserted on behalf of an alleged class in an amended complaint served on March 28, 1975 in *Carr* v. *New York Stock Exchange*, 414 F.Supp. 1292 (N.D. Cal. 1976). In *American Pipe & Construction Co.* v. *Utah*, 414 U.S. 538 (1974), the Supreme Court stated:

> "We are convinced that the rule most consistent with federal class action procedure must be that the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." (414 U.S. at 554)

Thus, the statute of limitations as to a claim asserted in a class action complaint is tolled as to all "asserted members of the class." As Judge Brieant held, 414 F.Supp. at 340 (JA 526), plaintiffs Arneil and Stockwell did not become "asserted members of the class" until the amended complaint was filed.

Plaintiffs in *Carr* v. *New York Stock Exchange, supra,* moved for a class determination on April 11, 1975—the date this action was filed in the Southern District of New York—and the motion was denied by Judge Spencer Williams on April 30, 1976. 414 F.Supp. 1292, 1303-05 (N.D. Cal. 1976). Plaintiffs concede that they were not within the class defined in the original complaint in *Carr* (Br. 9). Accordingly, they were not "asserted members of the class" at any time before March 28, 1975 when the amended complaint was served. Arneil and Stockwell were not within the original purported class of employees of Schwabacher and the defenses against them would differ from those

against the original plaintiffs in *Carr*. Accordingly, the greatest benefit which plaintiffs Arneil and Stockwell might derive from the *American Pipe* decision and the purported class action in *Carr* is that the statute of limitations might have been tolled as to them on March 28, 1975.

As Judge Brieant found, 414 F.Supp. 334, 339-40 (JA 524-26), this benefit is unavailing to plaintiffs' claims in this action. The three-year Washington statute of limitations had already expired before March 28, 1975 since there is no question that Arneil and Stockwell discovered that "proper disclosure of impending developments of the affairs of Blair . . . has not been made to us" before they sent their letter dated July 23, 1970.

Plaintiffs ignore the plain language in the *American Pipe* decision when they assert that the statute was tolled as to their claims when the original complaint in *Carr* was filed (Br. 29). Plaintiffs were not "asserted members" of the class on whose behalf claims were interposed on March 8, 1973. None of the authorities cited by plaintiffs supports a contrary reading of *American Pipe*. The mere amendment of the complaint in *Carr* did not make Arneil and Stockwell parties and even if they had become parties there would be no relation back under Rule 15(c) of the Federal Rules of Civil Procedure. *Murray B. Marsh Co.* v. *Mohasco Industries, Inc.* 326 F.Supp. 651 (C.D. Cal. 1971); *Higgins, Inc.* v. *Kiekhaefer Corp.*, 246 F.Supp. 610 (E.D. Wisc. 1965).

These undisputed facts establish that the causes of action based on Rule 10b-5 arose in Washington and are barred by the statute of limitations of that state.

POINT V

The Exchange Is Not Liable For Acts of Member Firms as a Controlling Person Under Section 20(a) of the Exchange Act.

Count IV alleges the Exchange was a controlling person of Blair and Schwabacher because it "supervised the activities of Schwabacher and Blair" and hence, it was "under a duty to plaintiffs in connection with the sale of the securities of Blair" (JA 20-21). Judge Brieant dismissed this count on the ground that it was barred by the statute of limitations. 414 F.Supp. at 340 (JA 526). This dismissal is also proper because the Exchange cannot be held liable as a controlling person of Blair or Schwabacher under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

The first decision to consider such a theory of liability of a national securities exchange was *Hughes* v. *Dempsey-Tegeler & Co., supra,* where the district court found that the Exchange could become a "controlling person," but found the Exchange not liable as a controlling person of Dempsey-Tegeler, a former Exchange member organization, since the Exchange had fulfilled its regulatory obligations under Section 6 within its good faith discretion and had no knowledge of any misrepresentations or omissions of others.

On appeal in *Hughes* the Exchange argued that it is a misapplication of law and the policy of self-regulation to characterize the Exchange as a "controlling person" of a member organization by virtue of the Exchange's actions pursuant to its Section 6 duty. The decision of the court of appeals stated:

> "We similarly reject Hughes' arguments concerning the vicarious liability of Dempsey for its employees or the vicarious liability of the Exchange as a 'controlling person' of Dempsey. In our view, this is simply an

inappropriate case for the 'fraud' provisions of the securities laws, even with their expansive interpretation." (534 F.2d at 177)

A controlling person claim was made against the Exchange in *Murphy* v. *McDonnell & Co.,* 71 Civ. 460 (S.D.N.Y. May 20, 1975), and rejected by Judge Owen at trial ("a regulatory body is chargeable to the extent it has to be regulated and not under some other additional or lesser duty"). (Trial Transcript at 2359)

Thoughtful consideration was given to the application of Section 20(a) to the Exchange in *Carr* v. *New York Stock Exchange, Inc.,* 414 F.Supp. 1292 (N.D. Cal. 1976). Judge Williams there rejected the analysis of Judge Lucas in the *Hughes* district court opinion. Judge Williams reviewed the purpose of Section 20(a) in the context of the self-regulatory system established by the Exchange Act and concluded:

> "Despite the broad reach given § 20(a) however, the purpose of the statute is misinterpreted if the direct or indirect control which forms the basis of liability is extended to the institutions created by the Act itself to regulate the securities markets. The present case is a clear example of the impossible Exchange position suggested by the plaintiff's interpretation of § 20(a). The Exchange is charged with a duty of regulating its member firms; the more closely it regulates, the more fully it becomes a 'controlling person', 'directly or indirectly' inducing the acts complained of, and the more susceptible to liability under § 20(a) it becomes. Moreover, this liability would attach whether the Exchange took positive actions in furtherance of a fraudulent scheme, or merely failed to prevent a fraudulent scheme on the part of its member firms. Under § 20(a) mere good faith or lack of knowledge of the scheme is not enough to avoid liability. *Moscarelli* v. *Stamm,*

288 F.Supp. 453 (D.C.N.Y. 1968); *Myzel* v. *Fields, supra.*" (414 F.Supp. at 1302-03)

The court in *Carr* dismissed the claims based on Section 20(a), stating:

> "A holding that a national securities exchange was a a 'controlling person' for the purposes of § 20(a) would inhibit regulatory flexibility, would be contrary to the congressional intent in establishing the self-regulatory exchange system in the Act and would place the Exchange in an untenable position of strict liability for the fraudulent acts of brokerage houses and their employees." (414 F.Supp. at 1303)

The purpose of the controlling person statute is to provide a theory of liability under which those persons who have caused others to participate in unlawful activities can be liable. See H.R. Rep. No. 152, 73rd Cong., 1st Sess. 276 (1933) and 78 Cong. Rec. 8094, 8095 (1934). The "controlling persons" section was not intended to apply to the statutory relationship, set forth in Section 6 of the Exchange Act, between a registered national securities exchange, a self-regulatory body, and its member firms which were to be regulated. If Congress had intended the possibility of a national securities exchange "controlling" its members and thus assuming vicarious liability for the members' violations of the applicable sections of the Exchange Act, Congress knew how to, and would have, explicitly prescribed this potentially vast liability in the Act. The legislative history shows that Congress wanted national securities exchanges to have the broadest discretion under Section 6. To impose "controlling person" liability for compliance with that congressional mandate would be contrary to the objectives of Section 6.

Conclusion

Judge Brieant's decision dismissing the counts under Section 6 should be affirmed on the ground that the claims are barred by the statute of limitations or, alternatively, that plaintiffs lack standing. The dismissal of Counts VI, IX, X (based on Section 6(a)(2), (3) and (4)) and XIV (based on fiduciary duty) must be affirmed since plaintiffs have abandoned any argument in support of the theory of those counts. Dismissal of Count XII should be affirmed for the reasons given by Judge Brieant.

The dismissal of Counts I, II, III, IV (based on Section 10(b)) and XIII (based on allegations of common law fraud) should be affirmed since they are barred by the statute of limitations of Washington which is applicable by virtue of the New York borrowing statute. In addition, dismissal of Count IV should be affirmed since an exchange has no controlling person liability for regulatory actions under the Exchange Act.

October 5, 1976

Respectfully submitted,

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